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No. 99-1214

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IN THE
Supreme Court of the United States

CATERPILLAR INC.,
CATERPILLAR FINANCIAL SERVICES CORPORATION,
and SOLAR TURBINES INCORPORATED,
Petitioners,

v.

THE NEW HAMPSHIRE DEPARTMENT OF REVENUE ADMINISTRATION and STANLEY R. ARNOLD, JR.,
THE NEW HAMPSHIRE COMMISSIONER OF REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of New Hampshire

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BRIEF OF *AMICUS CURIAE* COMMITTEE ON STATE TAXATION IN SUPPORT OF PETITIONERS

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

The Committee On State Taxation (COST) respectfully requests leave to file a Brief as *Amicus Curiae* in support of Petitioners. The interest of COST as *amicus curiae* is described *infra* at Brief, pp. 1-3. Counsel for Petitioners has consented to COST's filing of an *amicus* brief. Despite COST's qualifications to submit an *amicus* brief, Counsel for Respondents has refused to consent to the filing of such a brief. However, in the absence of such

permission there is a compelling reason for granting this request.

This Court should grant COST leave to file its *amicus* brief because COST has additional observations, not fully addressed by Petitioners, to make concerning the constitutional implications of the New Hampshire Business Profits Tax. Specifically, COST discusses why the income at issue being taxed by New Hampshire should not constitutionally be included in the tax base. While Petitioners raised this issue, it is further developed in COST's brief. COST also discusses the discrimination against affiliate capitalization structures resulting from the New Hampshire tax system. This discussion offers an alternative view and analysis of the discrimination against foreign commerce detailed by the Petitioners. Thus, COST's brief gives this Court both additional information and an additional method for analyzing the issues.

Respectfully submitted,

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BRIEF OF *AMICUS CURIAE* COMMITTEE ON STATE TAXATION IN SUPPORT OF PETITIONERS

INTEREST OF *AMICUS CURIAE*

This brief is submitted by the Committee On State Taxation (COST) as *amicus curiae* in support of Petitioners in the above captioned matter.[1] COST's ob-

[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioners has been obtained and filed with the Clerk of the Court.

jective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce and was separately incorporated on January 1, 1992. COST's membership consists of over 500 multistate corporations involved in interstate and international commerce.

COST is submitting this brief because systematic and distortive overcharging by state tax systems, such as the one at issue here, unconstitutionally discriminates against interstate commerce and impedes business's ability to operate in the global economy. New Hampshire has reached beyond its borders to unconstitutionally extract taxes from international business enterprises. *Amicus* hopes that this Court will not allow unconstitutional overcharging to quietly slide into established law and thereby be accepted by taxing authorities in New Hampshire and elsewhere. Such a diminution in taxpayers' constitutional protections threatens the foundations of the state tax system by risking excessive burdens on commerce. COST and its members are concerned that such burdens could become institutionalized elements of state tax systems. Further, New Hampshire's discriminatory method of taxing royalties and interest from foreign affiliates is shared by other states. Thus, not only are COST members with such foreign income unconstitutionally discriminated against in New Hampshire, but they are subject to similar unconstitutional systems in many other states. Thus, COST and its members have a particular interest in seeing the New Hampshire system reviewed (and invalidated) both because of the direct impact on the taxing scheme in New Hampshire and the resulting impact on other, similar state tax schemes. COST and its members request this Court to reiterate and expound upon the constitutional principles

prohibiting the tax on extraterritorial values and the discrimination suffered by Petitioners and many similar taxpayers in New Hampshire and elsewhere.

REASONS FOR GRANTING THE PETITION

COST asks this Court to accept this case to determine that New Hampshire violated the Commerce Clause of the United States Constitution by taxing income with no relation to the state and by taxing income from foreign affiliates differently, and more onerously, than income from domestic affiliates.

First, this case offers this Court the forum to complete its analysis as to what constitutes an unconstitutional tax on extraterritorial values [2] and, more importantly, to offer the state taxing jurisdictions a template to prevent future violations. While this Court has frequently stated that a state may not tax extraterritorial values, it has not previously had the opportunity to announce the exact indicia of when such unconstitutional extraterritorial taxation occurs. As a result, states have relied on a variety of incomplete shortcuts—such as a determination of a unitary business—to determine the income to be taxed. These shortcuts, while in some cases sufficient to meet constitutional strictures, fail in other situations (as evidenced here) to protect the taxpayer's constitutional tax limitations. Thus, a decision by this Court in this case is necessary to explain the imperative of considering these constitutional limitations against taxing extraterritorial values and the test for determining when such limits are violated.

Second, this Court has shown a consistent and unique interest in addressing and rectifying unconstitutional dis-

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[2] *See Allied-Signal Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *Hans Rees' Sons v. North Carolina ex re. Maxwell*, 283 U.S. 123 (1931).

crimination against interstate and foreign commerce [3] such as is woefully apparent here. Because of the Eleventh Amendment and the Tax Injunction Act, this Court offers the only federal forum for taxpayers and state taxing jurisdictions alike to have their state tax constitutional issues addressed in a uniform and nonpolitical environment. For these reasons, COST supports Petitioners' request for review and hopes that this Court will accept this case and find in favor of Petitioners.

Explanation of the New Hampshire Business Profits Tax

New Hampshire imposes a tax, the Business Profits Tax,[4] on all corporations doing business in the state. In determining the tax base, New Hampshire adopts the taxpayer's federal taxable income (with some unrelated adjustments). N.H. Rev. Stat. Ann. § 77-A:1, III. For multistate corporations, the amount of this total tax base that New Hampshire taxes is calculated according to the percentage of the taxpayer's property, payroll, and sales (the "apportionment factors") in the state. New Hampshire requires affiliated companies classified as a "unitary business" [5] to file a "combined return." Companies filing a combined return include the total income from each member of the group in a single tax base and determine the percent of the tax base taxable by the state according to the total of the entire group's payroll, property and sales in the state. §§ 77-A:3, I; 77-A:1, XIII. New Hampshire requires only domestic affiliates to be included in the combined return and excludes foreign affiliates.

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[3] In just the past few years, this Court has reviewed three state tax cases involving discrimination against interstate commerce: *Fulton*, *South Central Bell*, and *Hunt-Wesson*.

[4] N.H. Rev. Stat. Ann. Chapter 77-A. (1991 & Supp. 1998).

[5] While no universally applicable definition of unitary business exists, this Court has accepted the description as business "characterized by a flow of value among its companies." *Kraft Gen. Foods v. Iowa Dep't of Rev.*, 505 U.S. 71, 76 (1992).

§ 77-A:1, XV. Thus, to the extent that a New Hampshire taxpayer has a foreign affiliate, that affiliate's tax attributes (the income, expenses and apportionment factors of that affiliate) are excluded from the New Hampshire tax calculation.

In the instant case, the Petitioner companies doing business in New Hampshire have unitary foreign affiliates. Petitioners' domestic unitary group receives income from the foreign affiliates in the form of interest and royalties. Because the income is part of the Petitioners' domestic unitary group's federal taxable income, and because New Hampshire provides no deduction or exclusion for this income, the interest and royalties from foreign affiliates are included in the New Hampshire tax base. Conversely, New Hampshire does not allow the foreign affiliates' apportionment factors to be included in calculating the income taxable by New Hampshire because the foreign affiliates are not part of the return.

Royalties and interest from domestic unitary affiliates receive a different treatment than royalties and interest from foreign unitary affiliates. Like royalties and interest from foreign affiliates, such income from domestic affiliates is included in the New Hampshire tax base. (Technically, the income is included by eliminating both the expense deduction to the affiliate and the income to the parent). However, unlike the foreign income scenario, because the domestic affiliate is included in the combined report, not only is income representing the royalties and interest included in the tax base but the affiliate's apportionment factors are also included in the apportionment formula for the entire unitary group. The result is that to the extent that the affiliate generating the royalty and interest income has property, payroll, and sales outside of New Hampshire, some portion of the royalty and interest income will not be taxable by New Hampshire. This can

be contrasted to the foreign royalties and interest where no such accounting for factors outside of New Hampshire occurs because the foreign affiliates generating the income do not have representation in the apportionment factors. It is the inclusion of the royalty and interest income from foreign affiliates in the tax base that is at issue here.

ARGUMENT

I. Under the Commerce Clause of the United States Constitution, New Hampshire's Taxation of Caterpillar's Royalty and Interest Income from Foreign Affiliates Is Unconstitutional Because It Results in the Taxation of Extraterritorial Values.

A. *New Hampshire May Not Constitutionally Tax the Foreign Royalty and Interest Income Because It Is Unrelated To the In-State Activity.*

The Commerce Clause of the United States Constitution prohibits a state from taxing value unrelated to a taxpayer's activities in the state. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). Income can be taxed by the state if it has a variety of relationships with the state. For example, the income may have been directly earned by activities within the state—a sales person selling the taxpayer's product in the state. The income may also be taxed if it is part of the taxpayer's "unitary business." *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 425 U.S. 425 (1980). States are prohibited, however, from taxing income that bears no rational relationship to the in-state value of the corporate enterprise. *Allied-Signal*, 504 U.S. at 772.

In this case, New Hampshire does exactly what is prohibited by the constitution—taxes income earned outside the state with no rational relation to the activities occurring within the state. Petitioners' activities in the state clearly do not give rise to the foreign royalty and interest income; nor does New Hampshire treat the foreign affiliates as part of Petitioners' unitary business.

First, Petitioners' activities in New Hampshire are themselves unrelated to the generation of the foreign royalty and interest income New Hampshire attempts to tax and, thus, cannot be used as the basis for taxing the income. Petitioners and their domestic and foreign affiliates manufacture and sell engines and earth-moving equipment. Brief of Petitioners ("Pet. Br.") at 6. The *only* activity of Petitioners in New Hampshire is the sale of their products to independent dealers. *Id.* Petitioners do not manage their intangible property related to the contested income in New Hampshire, nor do they develop their intangible property in New Hampshire. Petitioners do not sell or advertise to the foreign market from New Hampshire. Similarly, they do not manage their foreign affiliates from New Hampshire; do not manage their loans from New Hampshire; and do not engage in any transactions from New Hampshire that promote or create the foreign income. All of those activities occur elsewhere, primarily abroad or at Petitioners' headquarters in Illinois.

Second, while Petitioners' stipulate that they are part of a unitary business with the foreign affiliates generating the foreign royalty and interest income, New Hampshire does not treat them for state tax purposes as unitary. New Hampshire's own taxing scheme excludes the foreign affiliates from the unitary group. New Hampshire also excludes the income, other than repatriated income, of the foreign affiliates from the tax base and excludes the foreign affiliates' factors entirely from the state apportionment calculation. Historically, this Court has found that a unitary relationship is usually sufficient to prove the requisite relationship to activity within the state. *Mobil Oil*, 425 U.S. 425. Since New Hampshire excludes the foreign affiliates from the combined return, it must also

exclude the income from those affiliates from the tax base. The Constitution requires the parallel treatment.

Even if the State succeeds in classifying the income as part of Petitioners' unitary business, the result is still an unconstitutional taxing of extraterritorial values. This Court has noted that merely being a unitary business does not mean that the net profits may be "attributed, regardless of the evidence" to any one state. *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 132 (1931). What is important is that "the method adopted [for taxation must be] reasonably attributable to the processes conducted within the borders of the State." *Id.* at 133. This Court in the same case went on to note that:

> But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State.

A perfect example of when a state, notwithstanding a unitary business relationship, may not tax income because the income was not related to the activities in the state is *British Land (Md.), Inc. v. Tax Appeals Tribunal of N.Y.*, 85 N.Y.2d 139, 647 N.E.2d 1280 (1995). In this case, the taxpayer earned a significant gain from the sale of real estate investments in Maryland that New York sought to tax. The taxpayer purchased the Maryland real estate in 1973 and did not have any business operations in New York until 1982. The court found that the taxpayer's real estate business in New York and in Maryland

was part of a unitary business, but also held that this was not the end of the analysis. The court found that "the gain on the Baltimore property was attributable in far larger part to "factors . . . present in other States but not present in [New York]." *Id.* at 148. The court noted that there was no "significant countervailing flow of value to petitioner's Maryland operation from its activities or the strategic decisions of its officers taking place outside of Maryland." *Id.*

Further, the court determined that any benefits to the Maryland operations from the taxpayer's other unitary affiliates could not be considered because the taxing jurisdiction's own tax regime did not include those affiliates in its tax calculation. This is exactly what happened in the current case. New Hampshire's own taxing scheme rejects the classification of Petitioners' foreign affiliates as unitary by excluding them from the tax base and apportionment factor calculation. Thus, some connection, other than the unitary relationship, must link the foreign generated royalties and income to the New Hampshire activities before that income can be taxed. No such relationship exists, and thus New Hampshire cannot constitutionally tax the income.

This Court has explained that "our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'" *Container*, 463 U.S. at 176. In Petitioners' case, New Hampshire fails to apply the correct standard in that it never considers whether the income is appropriately connected to the activities in the state.[6] If it had considered this standard, the result of upholding the imposition of the

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[6] The New Hampshire Supreme Court held only that the state's tax system did not discriminate against interstate commerce. It failed to consider whether the income in question was from extra-territorial values. Pet. Br. at 13a.

tax is not within the realm of permissible judgment because no rational connection between the foreign activities generating the income and Petitioners' New Hampshire activities exists. Taking *British Land* as the appropriate paradigm, New Hampshire may not constitutionally tax the foreign royalty and interest income and must exclude this income from its tax base.

B. *Even If There Is Some Rational Relationship Between Petitioners' Activities in New Hampshire and the Foreign Royalties and Interest, the Inclusion of That Income In the Tax Base Distorts Petitioners' New Hampshire Tax Out of All Appropriate Proportion To the Business Transacted By Petitioners In the State and, Thus, the Income Must Be Excluded From the Tax Base.*

Income that otherwise bears some minimal link to a taxing state is still constitutionally prohibited from being taxed if the resulting tax is "out of all appropriate proportion to the business transacted by the [taxpayer] in the state." *Hans Rees'*, 283 U.S. at 185.

Here, the inclusion of the foreign royalties and interest so inflates the resulting New Hampshire tax that under the "all appropriate proportion" test of *Hans Rees'*, the income must be excluded from the base (or some other taxing method adopted that will appropriately reflect the extent of Petitioners' activities in the state, such as the inclusion of the foreign factors of production giving rise to the income in question as suggested by Petitioners. Pet. Br. at 14). As Petitioners note, none of the more than thirty-five foreign subsidiaries and affiliates creating the foreign royalties and interest at issue transact any business within New Hampshire. Pet. Br. at 21. New Hampshire does not provide these foreign entities any benefits or protections that help in the generation of the foreign royalty and interest income. *Id.* Petitioners' total

New Hampshire payroll during the three years at issue herein totaled only $193,215 yet New Hampshire wants to claim that this paltry payroll was somehow related to $367,928,469 in royalty and interest income. *Id.* Either the New Hampshire sales force is superhumanly productive or New Hampshire is taxing extraterritorial values. The record supports the latter explanation.

This case is an even more obvious situation of extraterritorial taxation than *Hans Rees'*. In *Hans Rees'* this Court found that the state was unconstitutionally taxing income earned beyond its borders even though the activity in the taxing state was part of the ultimate stream of activities (manufacturing) giving rise to the income in question. Here, the activities in New Hampshire did not result in, promote, bring about, lead, influence, or subsidize the foreign activities creating the income. Thus, even if there is some connection between Petitioners' activities in New Hampshire and the activities creating the foreign royalties and interest, the tax imposed by New Hampshire as a result of those activities is out of all appropriate proportion to the activities occurring in the state. New Hampshire's imposition of the tax is therefore unconstitutional.

II. Under the Commerce Clause, New Hampshire Unconstitutionally Discriminates Against Petitioners' Foreign Affiliates Using a Specific Capitalization Method Because They Are Taxed Differently, and More Severely, than a Domestic Affiliate Using a Similar Capitalization Method.

In order for a tax to be constitutional under the Commerce Clause of the U.S. Constitution, it must "not discriminate against interstate commerce." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In *Kraft General Foods, Inc. v. Iowa Dep't of Rev. and Fin.*, 505 U.S. 71 (1992), this Court recognized that including dividends from foreign subsidiaries in the tax

base while excluding the dividends from domestic subsidiaries unconstitutionally discriminated against foreign commerce. In that case, this Court specifically rejected the state's argument that the taxpayer could have chosen another corporate structure to avoid the discrimination. *Id.* at 77. The current case involves the exact same problem: Petitioners' choice of capitalization alternatives for foreign affiliates resulted in different and more onerous tax treatment than a similar taxpayer's choice of capitalizing its domestic affiliates.

A business has many choices in how to invest in an affiliate. It may make a capital contribution in return for stock; it may make a loan in exchange for long-term principal repayment; it could operate the investment as an internal division rather than a separately incorporated entity; or it could provide management services, intellectual property, and know-how in exchange for a percentage of the affiliate's profit from operations. If a business makes a capital contribution as the means to finance the affiliate, one method of receiving a return on its investment is through dividends from the affiliate. If the business makes a loan to the affiliate, the return is in the form of interest payments. If a business offers services and property to the affiliate, it receives management fees and royalties in return.

In this case, Petitioners' domestic unitary group provided licenses of intellectual property and loans to the foreign affiliates as their chosen method of financing the foreign business enterprise. Instead of licensing the use of the intangible property, the domestic company could have contributed the foreign rights to the property outright in exchange for stock and any subsequent dividends. The operational result would not have changed—only the capital structure. Similarly, the domestic company could have operated the foreign operations as an internal divi-

sion and thus no transfer of property or income would have occurred. The same options exist for financing domestic operations. The problem in this case is that Petitioners' choice among financing alternatives for their foreign affiliates did not have the same New Hampshire tax results as a similar taxpayer's choice for financing domestic affiliates.

Amicus does not argue that there cannot be distinctions in tax treatment between different capitalization choices, but what is undeniably unconstitutional is a tax distinction between identical capitalization structures for a domestic affiliate versus a foreign affiliate. Unfortunately, this is exactly what New Hampshire imposes here—a taxpayer is subject to a higher tax if it receives royalties and interest from foreign affiliates as compared to receipts from domestic affiliates.

It is the choice in capitalization structure that distinguishes the current situation from the scenario adopted by the New Hampshire Supreme Court of a taxpayer receiving royalties and interest from an unrelated, domestic third party.[7] The New Hampshire Supreme Court found that no discrimination existed because the relevant comparison was between foreign unitary affiliates and domestic unrelated businesses. When a business licenses its property, or loans funds to an independent third-party it is because it is in the business of licensing and lending. However, when the same transaction occurs with an affiliate

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[7] The New Hampshire Supreme Court decided that:

> The foreign members of Caterpillar's unitary group are considered unrelated businesses . . . . Hence the proper comparison is between the foreign members of the unitary group and unrelated domestic entities.

Pet. Br. at 10a. By this statement, the court magically whisked away Petitioners' entire corporate structure. Petitioners did not treat these foreign affiliates as unrelated business entities and the court's chosen comparison is inaccurate.

it is to promote the overall capital structure of the business enterprise as a whole. Thus, the relevant comparison in tax treatment is between affiliated corporations.

New Hampshire, in its treatment of dividends, has recognized the principle articulated in *Kraft* that a state may not tax income from foreign sources more onerously than income from domestic sources. Under the New Hampshire tax statute, the foreign dividend payor's factors generating the foreign dividends are included in the state apportionment formula. N.H. Rev. Stat. Ann. § 77-A:3, II. Similar treatment is necessary in the current case to avoid a *Kraft*-like discrimination against foreign royalties and interest.

CONCLUSION

For the reasons stated above, and because this tax scheme is one confronted and challenged by taxpayers in several states, COST respectfully requests the Court to accept this case for review.

Respectfully submitted,

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